

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
U.S. TRUST CORPORATION	:	DETERMINATION
	:	DTA NO. 810461
for Redetermination of a Deficiency or for	:	
Refund of Franchise Tax on Banking Corporations	:	
under Article 32 of the Tax Law for the Years	:	
1985, 1986 and 1987.	:	

Petitioner, U.S. Trust Corporation, 114 West 47th Street, New York, New York 10036-1537, filed a petition for redetermination of a deficiency or for refund of franchise tax on banking corporations under Article 32 of the Tax Law for the years 1985, 1986 and 1987.

A hearing was commenced before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on December 1, 1993 and continued through December 3, 1993 when it was completed. Petitioner and the Division of Taxation filed briefs. Petitioner filed a reply brief on June 24, 1994, which began the six-month statutory period for issuance of this determination. Petitioner appeared by Edward M. Griffith, Jr., Esq. The Division of Taxation appeared by William F. Collins, Esq. (John Michaelson, Esq., of counsel).

ISSUES

I. Whether petitioner must include U.S. Trust of Delaware, Inc., a Delaware corporation not doing business in New York, in its combined franchise tax returns for the years 1985, 1986 and 1987.

II. Whether, if the combination of petitioner and U.S. Trust of Delaware is required, the Division of Taxation properly included thereceipts of U.S. Trust of Delaware as New York receipts for purposes of allocating income to New York.

III. Whether petitioner's eligible business facility credit must be calculated on a combined basis with its subsidiaries included in its combined report.

IV. Whether, if the eligible business facility credit must be calculated on a combined basis, the imposition of a penalty for substantial understatement of tax should be cancelled.

FINDINGS OF FACT

Petitioner, U.S. Trust Corporation ("U.S. Trust"), and the Division of Taxation (the "Division") entered into a stipulation of facts which was made part of the record of this proceeding. After the completion of the hearing, petitioner submitted 42 proposed findings of fact. The stipulated facts and the proposed findings of fact have been incorporated into this determination.

The Division issued to U.S. Trust six notices of deficiency, asserting tax deficiencies under Article 32 of the Tax Law for the years 1985, 1986 and 1987 as follows:

<u>Date of Notice</u>	<u>Year</u>	<u>Tax</u>	<u>Additional Charge</u>
12/14/89	1985	\$ 331,099.00	\$ -0-
12/14/89	1985	56,415.00	-0-
8/31/90	1986	568,627.00	39,673.00
8/31/90	1986	96,887.00	6,744.00
8/31/90	1987	1,024,798.00	86,370.00
8/31/90	1987	174,386.00	14,683.00

The notices of deficiency were issued as a result of an audit which was conducted on a joint basis by New York State and New York City auditors. New York City's auditor performed all of the field work and acted as the lead auditor.

U.S. Trust is a bank holding company registered under the Federal Bank Holding Company Act of 1956 (the "BHCA"). Its principal asset is a subsidiary, U.S. Trust of New York ("UST New York"), a New York commercial bank and trust company and a member of the Federal Reserve System. U.S. Trust specializes in trust and agency services. Principally through its subsidiary, UST New York, U.S. Trust provides a broad range of banking services and financial management and fiduciary services to individuals, corporations, pension funds and other institutions.

For the audit years, U.S. Trust filed combined franchise tax returns with three of its subsidiaries, UST New York, U.S. Trust Advisory Company, Inc., and Financial Technologies International, Inc. Upon audit of those returns, the Division redetermined the tax due in several

areas, only two of which are in issue here.

(a) U.S. Trust calculated an eligible business facility credit on a separate basis using only UST New York's income and allocation factors. The Division determined that this credit should be recalculated on a combined basis and recalculated the amount of the credit accordingly. As a result of this computation, the Division determined a tax deficiency of \$114,345.00 for the year ending December 31, 1985 and a total tax deficiency of \$1,260,434.00 for the years 1986 and 1987. A penalty was added for substantial understatement of tax, computed at 10% of the amount of the underpayment attributable to the understatement. This penalty was applied only to the understatement attributable to the calculation of the eligible business facility credit and not to other adjustments.

(b) U.S. Trust did not include one of its subsidiaries in its combined reports, U.S. Trust of Delaware ("UST Delaware"). The Division determined that U.S. Trust was required to file its corporation franchise tax report on a combined basis with UST Delaware and recomputed U.S. Trust's tax liability accordingly. This resulted in a tax deficiency of \$180,982.00 for the year ending December 31, 1985 and a total deficiency of \$282,783.00 for the years 1986 and 1987.

Because U.S. Trust challenged many of the factual conclusions reached by the Division on audit regarding combination with UST Delaware, it is worthwhile to quote the entire discussion on combination as it appears in the audit reports (there are two reports, one for 1985 and one for 1986 and 1987, but the narrative portions are almost identical).

"As previously mentioned, the taxpayer was filing on a combined basis with several of its' [sic] subsidiaries. Upon audit, it was discovered that the taxpayer had a 100% owned subsidiary (U.S. Trust Company of Delaware 51-0262277) that qualified for inclusion in the combined return.

"This corporation was set up to hold the stock of a banking corporation operating in Florida (U.S. Trust Company of Florida 59-2188338). U.S. Trust of Delaware is a passive holding company with its' [sic] only office in Delaware. The subsidiary only holds title to the stock of the Florida company and does not perform any substantial services or financing to this company. This subsidiary has only two part-time employees, a clerical person and an officer. The corporation is merely a shell company.

"The taxpayer has channeled large amounts of its' [sic] excess cash to U.S.

Trust of Delaware in the form of additional paid in capital for the purpose of having U.S. Trust of Delaware, rather than themselves, invest this cash in investments. These investments mostly involve government obligations. The taxpayer has stated that all investment decisions and transactions are made by the taxpayers' [sic] employees in New York.

"U.S. Trust of Delaware is very profitable and has only limited expenses. It appears that 100 per cent of its' [sic] gross income is from its' [sic] investment activities, which have been funded by the taxpayer through the transfer of interest free funds to U.S. Trust of Delaware. The taxpayer has transferred the record keeping activities of these investments from New York to the Delaware Subsidiary. This is not an arms-length transaction.

"This combination is being required because of the agreement, arrangement and transaction which transferred the record keeping activities of certain investments from New York to the Delaware Subsidiary and caused the activity, business, income and assets of the taxpayer within New York State to be improperly and inaccurately reflected.

"This combination is in accordance with Tax Law § 1462(f)(2)(i)(B) and Regulation §§ 21-2.6 and 21-2.3(b)(4)"

To counter the Division's conclusion that UST Delaware was nothing more than a shell corporation used by its parent to channel capital and income out of New York, U.S. Trust provided a history of UST Delaware from its formation in 1981 to its dissolution in 1990.

During the 1970's, UST New York found that its customer base was beginning to shift outside of New York to Florida and some of the sunbelt states. U.S. Trust wanted to expand its banking, trust and investment advisory business into Florida, California, Texas and other states in order to continue to service UST New York customers, attract new customers from those states and develop a national presence in the banking and trust industry.

U.S. Trust's plan to expand its operations outside of New York faced two primary legal obstacles. First, the McFadden Act prohibited UST New York from establishing branches in states other than New York. In addition, the Douglas Amendment to the BHCA (12 USC § 1842[d][1]) prohibited Federally-registered bank holding companies (like U.S. Trust) from owning banks in states other than their homes states, unless the laws of the other state expressly authorized such ownership.

Sometime in the 1970's, U.S. Trust established an investment advisory office in Florida. Kenneth Walsh, U.S. Trust's general counsel and a senior vice president during the audit years,

described the Florida office as a hand-holding operation for UST New York customers located in Florida. Because the Florida office could not offer investment or trust services to its customers, it risked losing them to local institutions; consequently, U.S. Trust began actively seeking ways to expand its Florida operations.

In about 1980, U.S. Trust applied for and received a state charter from the State of Florida to convert its Florida operation to a trust company, U.S. Trust of Florida, Inc. ("UST Florida"). In June 1982, U.S. Trust applied to the Comptroller of the Currency to convert UST Florida from a state-chartered trust company into a national association. This application was approved in August 1983. Subsequently, U.S. Trust's legal department determined that U.S. Trust might avoid the Douglas Amendment's prohibition against interstate ownership of banks through the use of the "non-bank bank" loophole of the BHCA. The BHCA defines a "bank" as an institution that both accepts time and demand deposits and engages in the business of making commercial loans (12 USC § 1841[c]); a non-bank bank is one which does not engage in both of these activities.

U.S. Trust determined that if its advance into the Florida market was to be successful, it would be preferable to vest the ownership of UST Florida in a non-bank corporation, not incorporated in New York. There were several reasons for this decision. First, local banks and bank regulators were hostile to the encroachment into their market by out-of-state banks, especially those from New York. U.S. Trust believed that direct ownership of UST Florida and other interstate entities by a non-New York corporation would reduce that hostility. In addition, those states into which U.S. Trust considered expanding, Florida, California and Texas, are unitary taxing jurisdictions and might require combination of U.S. Trust and its New York subsidiaries with any subsidiary in their jurisdictions. On the advice of tax counsel, a non-New York State holding company was deemed advisable to attempt to insulate New York income, activities and property from tax in those states. In addition, U.S. Trust believed that if the Federal Reserve Board rejected its proposal for a non-bank bank, a corporation not registered under the BHCA (i.e., not a bank holding company under that law) might still avoid the

interstate prohibition of the Douglas Amendment. Finally, U.S. Trust's legal advisors believed that UST Florida's parent should restrict its investments so as not to run afoul of the Federal Reserve Board's broad definition of commercial lending. U.S. Trust believed that it would be easier to accomplish this in a newly-formed corporation than to conform U.S. Trust's existing investment policies and investments.

In November 1981, U.S. Trust formed UST Delaware under the laws of the State of Delaware as a wholly-owned subsidiary. In December 1981, U.S. Trust contributed all of the shares of UST Florida to UST Delaware as a contribution to capital.

In November 1983, U.S. Trust applied to the Federal Reserve System Board of Governors for approval to expand the non-banking activities of UST Florida to include the acceptance of deposits and the granting of consumer loans. The application was approved in March 1984; however, the Federal Reserve Board noted that the application raised significant issues with the potential for undermining the policies of the BHCA and recommended legislation to close the non-bank bank loophole. U.S. Trust's proposal was opposed by the State of Florida, the Florida Bankers Association, the Conference of State Bank Supervisors, and the Sun Bank/Palm Beach.

In April 1984, the Florida Department of Banking and Finance, the Florida Banker's Association and the Sun Bank/Palm Beach commenced an action against the Federal Reserve Board of Governors in Federal court for a review of the Board's order approving the expansion of UST Florida's powers. This action was finally decided in U.S. Trust's favor in 1986 in Florida Dept. of Fin. v. Board of Governors (800 F2d 1534, on remand from the Supreme Court of the United States, 474 US 1098).

From as early as 1981, U.S. Trust had actively considered the feasibility of moving certain of UST New York's operations out of New York State to either New Jersey or Delaware. U.S. Trust began its own internal studies focusing on the possibility of relocating UST New York's corporate trust and unit trust divisions from New York City to Delaware. In 1984, Fantus Company was hired to perform a feasibility study. It determined that the corporate trust

and unit trust divisions were the prime candidates for relocation and that Delaware offered the most favorable operating environment.

Delaware's interstate banking provisions required that a certain amount of capital be placed within the state if the trust units were to be transferred to UST Delaware. Moreover, Federal banking laws and regulations would require that UST Delaware obtain substantial capital before either or both operations could be transferred to it.

U.S. Trust contributed substantial amounts of capital to UST Delaware during the period 1982 through 1986 in anticipation of interstate banking acquisitions, the need for additional capital in operating subsidiaries, and the contemplated move of segments of UST New York's business to Delaware. UST New York was the major source of income for the U.S. Trust Group. Because of dividend restrictions under the Federal banking laws and regulations, it took several years to build up capital and pass it up from UST New York to U.S. Trust and then down to UST Delaware. From July 1, 1982 through December 19, 1986, U.S. Trust made capital contributions to UST Delaware as follows:

<u>Date</u>	<u>Amount</u>	<u>Cumulative</u>
7/1/82	\$ 2,001,000.00	\$ 2,001,000.00
8/9/82	4,038,064.01	6,039,064.01
1/28/83	2,625,000.00	8,664,064.01
11/15/83	5,015,622.81	13,679,686.82
4/24/84	19,200,000.00	32,879,686.82
4/24/85	3,000,000.00	35,879,686.82
12/19/86	8,000,000.00	43,879,686.82

During the period from June 1982 to October 1986, UST Delaware made the following capital contributions to UST Florida:

<u>Date</u>	<u>Amount</u>
6/24/82	\$2,000,000.00
6/19/84	1,000,000.00
2/19/86	1,000,000.00
8/20/86	1,000,000.00
10/29/86	<u>2,518,437.00</u>
Total	\$7,518,437.00

In 1983, UST Delaware and a number of Saudi Arabian investors formed Saudi-U.S. Trust Company Limited ("Saudi-UST"), to provide investment management and fiduciary

services to residents of middle eastern countries. During the period 1983 through 1986, UST Delaware contributed \$5,000,000.00 to the capital of Saudi-UST. Saudi-UST did not prove profitable and was liquidated in June 1986.

Throughout the 1980's, U.S. Trust actively sought to expand its banking, trust and investment advisory activities into California, Texas and other states. Acquisitions were made in California and Texas and considered in St. Louis, Missouri; Portland, Oregon; Boston, Massachusetts and Wilmington, Delaware.

In October 1986, UST Delaware acquired the assets of Summit Management Company, Inc. ("Summit"), a California-based investment advisory company, for \$4,350,630.00. The assets of Summit were later merged into U.S. Trust of California, Inc. ("UST California"), a newly-formed wholly-owned subsidiary of UST Delaware. After the merger, UST California became a state-chartered trust company and was later converted to a national association with limited banking powers.

During the period from November 1987 to January 1990, UST Delaware made the following capital contributions to UST California:

<u>Date</u>	<u>Amount</u>
11/13/87	\$1,000,000.00
1/4/88	3,000,000.00
2/18/89	450,000.00
1/13/90	<u>450,000.00</u>
Total	\$4,900,000.00

In 1989, UST Delaware formed a wholly-owned subsidiary, UST Deltex, Inc. ("Deltex"), a Delaware corporation, to hold the shares of its Texas subsidiaries. This was done because Texas counsel thought it advisable to insulate UST Delaware from the Texas operations for Texas franchise tax reasons. In June 1989, Deltex acquired the shares of Denker and Goodwin, a Texas investment advisory company, for \$3,700,000.00. Thereafter, U.S. Trust of Texas ("UST Texas") was formed as a state-chartered trust company and was made a subsidiary of Denker and Goodwin. To provide UST Texas with required capital, Denker and Goodwin downstreamed all of its assets to UST Texas.

In 1989 and 1990, UST Delaware made the following capital contributions to Deltex:

<u>Date</u>	<u>Amount</u>
6/26/89	\$ 3,000.00
7/2/89	3,700,000.00
7/12/89	500,000.00
8/3/90	<u>500,000.00</u>
Total	\$4,703,000.00

In January 1990, U.S. Trust placed itself on the Federal Deposit Insurance Corporation's ("FDIC") failed bank list and began receiving invitations from the FDIC to bid on failed Texas banks.

In December 1990, USTLPO Corp., a wholly-owned Delaware subsidiary of U.S. Trust, acquired certain of the assets of First National Bank of Rowlett, Texas, and later placed those assets in U.S. Trust Company of Texas N.A. UST Texas, the state-chartered trust company, was later merged into U.S. Trust of Texas N.A.

U.S. Trust liquidated UST Delaware in December 1990. The decision to liquidate was brought about by both legal and economic considerations. UST Delaware was not registered as a bank holding company under the BHCA. Before 1990, the Federal Reserve Board allowed UST Delaware to own UST Florida because it took the view that non-bank banks were not "banks" within the meaning of the BHCA.

In 1987, Congress enacted legislation amending the definition of a "bank" under the BHCA to include all non-bank banks which accepted insured deposits ("the Amendment"). The Amendment contained certain "grandfather provisions" for both bank holding companies and non-bank holding companies. Petitioner believed that the grandfather provisions relating to bank holding companies applied to it and excluded non-bank banks acquired before March 5, 1987, the effective date of the Amendment. In the years after the Amendment, U.S. Trust believed that the Federal Reserve agreed with its interpretation. However, in October 1990, in connection with an attempted acquisition of certain assets of a Texas bank by UST Delaware, the Federal Reserve advised that UST Delaware could not acquire these assets because UST Delaware fell within the grandfather provisions relating to non-bank holding companies (12

USC § 1843[f]) which precluded such an acquisition. Under this view, U.S. Trust believed that UST Delaware's continued ownership of UST Florida would be in violation of the BHCA.

In addition, the Federal Reserve Board, as well as certain credit rating institutions, such as Standard and Poor's and Moody's, were concerned with U.S. Trust's "double leverage" (the relationship between U.S. Trust's equity and the equity in its subsidiaries). Unless improved, this double leverage problem would adversely affect U.S. Trust's credit rating, customer confidence and possibly its cost of borrowing. U.S. Trust was able to cure UST Delaware's possible violation of the BHCA and substantially improve its double leverage problem by liquidating UST Delaware.

During the audit period, UST Delaware had offices in Wilmington, Delaware. Its only full-time employee was Peter W. McNeily who served as executive vice president and chief investment officer of UST Delaware from 1984 until the corporation's liquidation in 1990. Mr. McNeily had a substantial amount of banking and investment experience. In 1970 he began working for American Express Credit Corporation as its president and served in that capacity until his retirement in 1984. The credit corporation was the financing arm of the credit card company and was responsible for finding sources of money with which to purchase the cash receivables of the credit card operation. The other officers of UST Delaware were Trowbridge Callaway, President; James Brasco, Comptroller; and Kenneth Walsh, Corporate Secretary. Mr. Callaway was president of UST Florida and a member of UST Delaware's board of directors. Mr. Brasco was the comptroller of U.S. Trust, and, as noted, Mr. Walsh was general counsel of U.S. Trust.

In 1985, UST Delaware's board of directors included, in addition to Mr. Callaway: H. Marshall Schwartz, Edwin A. Heard, Thomas Killefer, Edwin D. Etherington, Howard L. Clark, and Chester W. Nemitz, Jr.; Mr. Nemitz was replaced by Brent M. Abel in 1986; the other board members served throughout the audit period. All of these individuals, except Mr. Callaway, were also directors of U.S. Trust. Mr. Schwartz and Mr. Heard were employees of U.S. Trust and received no compensation for their service as members of the board of directors.

The outside directors of UST Delaware (those not employed by U.S. Trust or one of its subsidiaries) were compensated by UST Delaware.

As noted above, U.S. Trust's legal advisors believed that the immediate parent of UST Florida would be required to follow a very restrictive investment policy to avoid violating the Federal Reserve's definition of commercial lending. One of U.S. Trust's reasons for forming UST Delaware was to create a parent corporation for UST Florida which could follow such an investment policy. The investment policy of UST Delaware was adopted by the UST Delaware board of directors.

UST Delaware's investment securities were physically located in New York City pursuant to a custodial agreement between UST Delaware and UST New York. The custodial agreement provides that UST New York is to provide the following services to UST Delaware:

"1. SAFEKEEPING

You will provide for the physical safekeeping of property, making use of other depositories as you consider advisable. Registered securities are to be held in the name of a nominee maintained by you or by any such depository.

"2. TRANSACTIONS

You are to process security transactions upon receipt of authorized telex, written instruction or oral instruction confirmed in writing. Brokers will be instructed to send you confirmations of security transactions.

Trading Facilities

Subject to your policies and procedures and with your consent, security transactions may be processed through your trading facilities.

"3. INCOME COLLECTION

You are to collect and credit to this account all income, holding it subject to authorized instructions.

"4. REPORTS

You are to provide:

Pt A monthly statement of security transactions and cash receipts and disbursements.

Pt A list of property in the account, quarterly.

Pt Advices of security transactions, on actual settlement dates.

Pt Notification of calls, maturities, redemptions, or retirement of any of the securities.

"This material should be sent to the following individuals:

Mr. T. Callaway
Mr. E. Heard

"5. YOUR COMPENSATION

Basic Custody Services

See Schedule A"

UST Delaware paid UST New York fees of about \$25,000.00 annually for the services provided under the custodial agreement. The fees paid were determined according to a rate schedule which was also used for unrelated third-party clients with similar size security portfolios during the years in issue. The fees were determined based on safekeeping charges and security transaction charges. The fees paid by UST Delaware amounted to about 10 percent of UST Delaware's expenses in each of the years in issue and were a small percentage of UST New York's receipts in each of the years in issue.

It was not uncommon for UST New York, acting as custodian of a trust account, to execute investment transactions within specific parameters established by the client. For instance, a client might instruct the custodian to reinvest money from a maturing Treasury Bill in another 90-day Treasury Bill. UST New York's traders executed these transactions through established brokerage houses, but they did not make the underlying investment decisions. UST New York did not charge its custodial customers a separate fee for executing transactions within a specific set of guidelines.

The board of directors of UST Delaware adopted investment guidelines for that corporation consistent with the goal of avoiding investments which might violate the Federal Reserve Board's definition of commercial loans. Mr. McNeily described his primary duty as ensuring that investments selected by the UST New York traders were consistent with the policies established by the UST Delaware board of directors. Although Mr. McNeily was not a member of the board, he attended board meetings to report on UST Delaware's investments. Mr. McNeily usually received information regarding any trades or investments made by the UST New York traders on the following day. These generally consisted of brokerage

statements. Petitioner offered in evidence a group of Prudential-Bache brokerage statements showing U.S. Trust of Delaware, Inc. as the customer and addressed to Mr. McNeily in Delaware.

In addition to monitoring UST Delaware's investments, Mr. McNeily, assisted by a part-time clerical staff member, performed administrative and bookkeeping tasks. He maintained a ledger of transactions, including the investment transactions; prepared income and loss statements, balance sheets and other financial statements; and maintained the local office, using a Delaware checking account for office expenses. Payroll checks for Mr. McNeily and his assistant were prepared by UST New York, which acted as paymaster for all of the U.S. Trust subsidiaries. It was also Mr. McNeily's responsibility to act as the public face of U.S. Trust in Delaware. Beginning when he worked for American Express and subsequently when he was employed by UST Delaware, he was a member of the board of directors of Winterhur Corporation Council, a group of about 50 local firms that raised money for the Winterhur Museum. In addition, he attended meetings with U.S. Trust and Delaware officials to discuss the possible relocation of some UST New York business operations to Delaware.

In September 1984, members of U.S. Trust's senior management, together with Peter McNeily as an officer of UST Delaware, met with Delaware's Lieutenant Governor, Delaware's Superintendent of Banks, the Mayor of Wilmington and other government and community leaders to discuss relocating certain of U.S. Trust's business operations to Delaware.

In the long run, none of UST New York's business operations were relocated to Delaware. U.S. Trust determined that the transfer would face legal obstacles under New York law. In addition, the Fantus study concluded that it would not be feasible to transfer the necessary number of trained and experienced employees to Delaware. Finally, U.S. Trust concluded that it was not in a position to make the necessary long-term capital commitment to UST Delaware to support the corporate unit trust and unit trust operations.

There is no evidence that UST Delaware had an office or employees in New York State or owned property in New York State other than securities which were in the possession of UST

New York for safekeeping under the terms of the custodial agreement. UST Delaware did not do business in New York.

The examination of the books and records of U.S. Trust was performed in New York City by Irving Milstein, a New York City auditor. Based on information provided by U.S. Trust, the Division arrived at several conclusions. It concluded that the officers and boards of directors of UST Delaware and U.S. Trust were so intertwined that all decisionmaking was actually being made by U.S. Trust, in New York, for UST Delaware. Based on records showing a regular pattern of telephone calls made by Mr. McNeily to U.S. Trust in New York and even more telephone calls to Mr. McNeily by persons in New York, the Division concluded that investment decisions were all being made in New York and that Mr. McNeily was not involved with the purchase or sale of securities. Mr. Milstein never spoke directly with Mr. McNeily during the course of the audit. Mr. Milstein saw payments made to attorneys for what he described as work performed for UST Florida and UST California. He identified these as payments made by U.S. Trust on behalf of UST Delaware, and he saw no evidence of reimbursement. Mr. Milstein also noted that U.S. Trust prepared the payroll checks for UST Delaware.

In conducting its audit, the Division reviewed the Federal consolidated corporation income tax returns of U.S. Trust for fiscal years 1985, 1986 and 1987. Details of the 1986 return are selected here as exemplary of the returns for the three audit years. On the 1986 return, UST Delaware is shown as having gross income of \$3,364,565.60, primarily from interest on its investments, and expenses of \$317,272.43. Schedule M of the return shows a reconciliation of income per books with income per tax returns for 1986. Under the category of expenses recorded in the books of UST New York but not deducted on the group's consolidated tax return was an expense in the amount of \$425,666.91 for capital acquisition costs associated with Summit (a subsidiary of UST Delaware).

The witnesses for the Division (Mr. Milstein and another auditor, Michael Shanahan) testified that the Division considered making adjustments to U.S. Trust's income or expenses in

order to cure any distortion in New York income identified by the Division, but concluded that it would be too difficult to make such adjustments. The possibility of making remedial adjustments to cure distortion was not discussed with representatives of U.S. Trust. The field audit report and workpapers make no reference to the possibility of performing remedial adjustments. An internal Division memorandum, dated August 25, 1988, and the narrative portion of the Field Audit Report(s) cite to the Division's statutory authority to combine U.S. Trust and UST Delaware, but neither document refers to the statutory provisions which authorize the Division to make remedial adjustments to cure distortion of income.

UST Delaware's tax returns were prepared by the tax department of U.S. Trust. U.S. Trust was not reimbursed by UST Delaware for that service. The tax manager for U.S. Trust, Michael Scarpinato, testified that all legal bills paid by U.S. Trust are listed on a schedule attached to U.S. Trust's Federal income tax return. The tax department analyzed the bills to determine whether they were properly those of U.S. Trust or a subsidiary. The expense was reported on the return of the subsidiary that incurred the expense so that taxable income for each subsidiary properly reflected legal fees paid. Mr. Scarpinato explained the tax treatment of the \$425,000.00 expense incurred by UST New York in connection with the acquisition of Summit by UST Delaware (see, Finding of Fact "41"). UST New York's income per books was reduced by \$425,000.00 to reflect that expense. Since UST Delaware did not reimburse UST New York, the incurring of the expense would result in a reduction of UST New York's income. However, UST New York did not treat the expense as a deduction from income for Federal tax purposes, effectively increasing its Federal net income by \$425,000.00. Since Federal net income is the starting point for calculating New York taxable income, this reconciliation would result in an accurate reflection of New York taxable income.

Petitioner filed a Claim for Tax Credit-Eligible Business Facility (Form CT-45) for each of the years in issue. Petitioner calculated the eligible business facility credit on a separate basis in each year, identifying UST New York as the taxpayer. The credit is calculated as a factor of the banking corporation franchise tax otherwise due and is comprised of the average of two

percentages -- the eligible property percentage and the eligible wage percentage. In calculating these percentages, petitioner used only the property and wages of UST New York, apparently on the theory that UST New York was the actual owner of the property which qualified as an eligible business facility. Attached to the CT-45's were certificates of eligibility. The employer identification number shown on each certificate is that of U.S. Trust and U.S. Trust is identified as the qualifying employer in each case.

Line 5 of the CT-45 states: "Tax before credit - Schedule A, Form CT-3, CT-32 or CT-33." For tax year 1985, petitioner entered the separate tax liability of UST New York taken from the CT-32 filed by UST New York.¹ The separately computed tax credit percentage was applied to

this amount to compute the tax credit. The amount of the credit was then entered on the combined report, Form CT-32A, on line 6, and a CT-45 was attached.

SUMMARY OF THE PARTIES' POSITIONS

In its brief, the Division takes the position that where the 80% stock ownership requirement is met, affiliated banking corporations are mandated to file on a combined basis, even though one of the corporations is not a taxpayer under Article 32. It goes on to say that this mandatory combined filing requirement is a significant difference from the combined filing requirements for business corporations under Article 9-A of the Tax Law and places the burden

¹Each banking corporation subject to the franchise tax on banking corporations is required to file an annual return (Form CT-32) (Tax Law § 1462[a]). Affiliated taxpayer corporations in which there is 80% or more control or ownership of voting stock must file combined returns (Form CT-32A) (Tax Law § 1462[f][i]-[iii]). Thus, each of the U.S. Trust corporations subject to the franchise tax was required to file a separate return and was properly included in U.S. Trust's combined return. For the years 1986 and 1987, the Division placed in evidence the Form CT-32A combined return only. For 1985, the separate returns of each of the affiliated New York corporations were placed in evidence by the Division. Petitioner placed in evidence copies of the separate return of UST New York (Form CT-32) for 1985, 1986 and 1987. Since the filing of the separate returns was not raised as an issue on audit or at hearing, it will be concluded that the required returns were all properly filed with the Division.

on taxpayers to establish that separate filing is necessary to properly reflect the tax liability. Petitioner states that this reading of the statute is erroneous and ignores specific language in the statute which states that where one of the banking corporations is not a taxpayer, combined filing cannot be required unless other conditions are met.

Petitioner argues that as a condition precedent to requiring the combination of UST Delaware with U.S. Trust, the Division was obliged to attempt to cure any distortion in New York income through the application of the remedial adjustments provided for in Tax Law § 1462(g). The Division never directly addressed petitioner's contention that the attempt to make remedial adjustments is a condition precedent to combination; however, the Division asserts that the possibility of making such adjustments was considered on audit and determined to be impossible.

Petitioner contends that there were no substantial intercorporate transactions between UST Delaware and U.S. Trust. The Division claims that U.S. Trust's contributions of capital to UST Delaware constitute intercorporate transactions. Moreover, the Division argues that U.S. Trust provided services to UST Delaware for which U.S. Trust was never compensated, including those services related to the acquisition of the subsidiaries of UST Delaware.

It is petitioner's position that UST Delaware was formed for sound business reasons, that capital was contributed to UST Delaware to serve those business purposes and that there were no unfair agreements, understandings, arrangements or transactions between UST Delaware and U.S. Trust or any of its subsidiaries. Consequently, petitioner argues that the Division is without authority to require combination because of any such agreement. The Division responds by saying that the only requirement for combination is the existence of an intercorporate relationship and agreements which result in an improper reflection of income.

If it is determined that combination is appropriate, petitioner argues that UST Delaware's receipts (all of which were from its investments) are not includable in combined receipts for entire net income allocation purposes. According to petitioner, the greater portion of UST Delaware's income-producing activities occurred in Delaware where the day-to-day investment

decisions and support activities were located. The Division claims that the Delaware office of UST Delaware was nothing more than a bookkeeping facility and that all decisionmaking of any significance was done in New York. Consequently, the Division argues, UST Delaware's receipts should be treated as New York source receipts.

Petitioner contends that the Division's regulation requiring the computation of the eligible business facility credit on a combined basis is contrary to the statutory provision providing for such a credit and the intent of the Legislature. The Division counters that statutes creating tax credits are to be strictly construed against the taxpayer. Moreover, the Division argues that its regulatory interpretation of the statute must be upheld unless it is clearly irrational or unreasonable, and it states that its interpretation of the relevant statute is reasonable.

Petitioner claims that it adequately disclosed the computation of its eligible business facility credit so that even if computation of the credit on a combined basis is required, the Division is without authority to impose a penalty based on substantial underreporting of the tax due. In addition, petitioner argues, its calculation of the credit on a separate basis was consistent with the directions given on the tax forms promulgated by the Division. Finally, petitioner contends that it acted in good faith when it calculated the credit on a separate basis. The Division did not address this issue.

CONCLUSIONS OF LAW

A. New York State has imposed a franchise tax on banks since 1927 (L 1926, ch 286). Article 32 was added to the Tax Law in 1973, replacing Articles 9-B and 9-C of the Tax Law which previously contained the provisions imposing the franchise tax on banks (L 1972, ch 167). In 1985, Article 32 was substantially revised to make the tax on banks more like the franchise tax imposed on business corporations (L 1985, ch 298). Tax Law former § 1462(f), which provided for the filing of "consolidated" returns by affiliated corporations, was repealed and replaced with the current provision which is similar to Tax Law § 211.4, the statutory provision which provides for the filing of combined reports by affiliated business corporations.

Basically, Tax Law § 1462(f) requires or permits combination based upon certain stock ownership requirements, provided that any bank holding company or corporation not subject to tax imposed by Article 32 may not be subject to combination unless certain conditions exist.

The Division correctly notes that Article 32 differs from Article 9-A in that Article 32 mandates the filing of combined reports by affiliated taxpayers where there is 80% or more control or ownership of voting stock, while Article 9-A states that combined filing may be permitted or required at the discretion of the Division (Tax Law § 211.4). However, the Division goes on to argue that since UST Delaware is a banking corporation as defined by section 16-2.5(j)(1)(i) of the regulations ("any corporation whose voting stock is 65 percent or more owned or controlled, directly or indirectly, by a bank holding company"), it is subject to the general rule of mandatory combination. As petitioner notes, this is an erroneous interpretation of the statute which ignores several statutory provisions.

Tax Law § 1462(f)(2)(i) provides as follows:

"Any banking corporation or bank holding company which is exercising its corporate franchise or doing business in this state in a corporate or organized capacity, and

"(A) which owns or controls, directly or indirectly, eighty percent or more of the voting stock of one or more banking corporations or bank holding companies, or

"(B) whose voting stock is eighty percent or more owned or controlled, directly or indirectly, by a banking corporation or a bank holding company,

"shall make a return on a combined basis under this article covering itself and such corporations described in clause (A) or (B) and shall set forth such information as the tax commission may require unless the taxpayer or the tax commission shows that the inclusion of such a corporation in the combined return fails to properly reflect the tax liability of such corporation under this article. Provided, however, that no banking corporation or bank holding company not a taxpayer shall be subject to the requirements of this subparagraph unless the tax commission deems that the application of such requirements is necessary in order to properly reflect the tax liability under this article, because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in subsection (g) of this section" (emphasis added).

Pursuant to the statute, an affiliated banking corporation which is not a taxpayer is not required or permitted to file on a combined basis unless such combination is deemed necessary to properly reflect the taxpayer's tax liability. In its brief, the Division erroneously contends that

UST Delaware is a taxpayer subject to the tax imposed by Article 32 and, therefore, subject to the general rule of mandatory combination.²

There is no question that UST Delaware is a banking corporation as that term is defined by statute and regulation (see, Tax Law § 1452[a][2], [9]; [b]). Petitioner has not claimed otherwise. The franchise tax is imposed on "every banking corporation" for "the privilege of exercising its franchise or doing business in [New York]" (Tax Law § 1451[a]). A "taxpayer" is defined to mean a corporation or association subject to the tax imposed by Article 32 (Tax Law § 1450[a]). Thus, a banking corporation is subject to the bank tax only if it is exercising its corporate franchise or doing business in New York. Tax Law § 1462(f)(2)(i), which the Division cites as authority for its contention that combined reporting of UST Delaware and U.S. Trust is mandated by statute, specifically limits the combined reporting rules to "[a]ny banking corporation . . . which is exercising its corporate franchise or doing business in [New York]." There is no evidence that UST Delaware was exercising its corporate franchise or doing business in New York in the audit years (see, 20 NYCRR 16-2.7 for a discussion of what constitutes doing business in New York), and the Division has never even made the claim that it was doing so. Consequently, UST

Delaware was not a taxpayer during the audit years, was not required to file a return under Article 32 (20 NYCRR 21-1.1) and may not be required to file a tax return on a combined basis with U.S. Trust unless combined reporting is necessary to properly reflect U.S. Trust's Article 32 tax liability "because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in [Tax Law § 1462(g)]" (see also,

²On audit, the Division never took the position that UST Delaware was a New York taxpayer. This argument was first offered by the Division in its brief. In fact, in his opening statement at hearing, the Division's representative stated that one of the issues to be addressed was whether the Tax Law "required combination of a New York State bank and a non-taxpayer, a non-New York taxpayer" (tr., p. 11). The Division's attorney never explained this reversal in the Division's position.

20 NYCRR 21-2.6).

B. Tax Law § 1462(g) provides, in pertinent part:

"In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized or empowered, in its discretion and in such manner as it may determine, to adjust items of income or deductions in computing entire net income or alternative entire net income and to adjust assets, and to adjust wages, salaries and other personal service compensation, receipts or deposits in computing any allocation percentage, provided only that entire net income or alternative entire net income be adjusted accordingly and that any asset directly traceable to the elimination of any receipt be eliminated from assets so as to accurately determine the tax. If however, in the determination of the tax commission, such adjustments do not, or cannot effectively provide for the accurate determination of the tax, the commission shall be authorized to require the filing of a combined report by the taxpayer and any such other corporations."³

The various adjustments described by the statute are commonly referred to as "remedial adjustments", and the purpose of such adjustments is to provide for the accurate determination of the tax or "to cure distortion". It is petitioner's position that section 1462(g) places the Division under

an obligation to attempt to make these remedial adjustments before it can require combination.

Petitioner reasons that the Division cannot be in a position to determine whether remedial adjustments will result in accurate reporting of the tax unless it first attempts to make such adjustments. For this reason, petitioner considers an attempt by the Division to make remedial adjustments to be a condition precedent to combination. In this proceeding, the Division did not address petitioner's interpretation of the statute. It merely states in its brief that the auditors "first determined that it would be impossible to make remedial adjustments . . . because the

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Effective September 1, 1987, references in the Tax Law to the State Tax Commission are deemed to refer to the Commissioner of Taxation and Finance, except where such references relate to the administrative hearing process (Tax Law § 2026). The references to the Tax Commission in Tax Law § 1462(g) may be deemed to refer to the Commissioner of Taxation and Finance.

activities of the various corporations were so intertwined as to make corrective adjustments impossible" (Division's brief, p. 11). This issue raises two questions: (1) whether Tax Law § 1462(g) obliges the Division to make a determination that remedial adjustments do not, or cannot, cure distortion before requiring combination and, if so, (2) what level of effort is required of the Division to show that its determination is reasonable.

This is the first adjudicatory proceeding to consider the proper interpretation of section 1462(g) and, therefore, begins as a matter of pure statutory reading and analysis. The principal rule of construction is to ascertain and give effect to the intention of the Legislature. In the first instance, the intention of the Legislature is to be sought from a literal reading of the act itself. If the language of the statute is clear and unambiguous, there is no occasion to resort to any other means of interpretation (see, Matter of Allstate Ins. Co. v. Libow, 106 AD2d 110, 482 NYS2d 860, affd 65 NY2d 807, 493 NYS2d 128).

The first sentence of Tax Law § 1462(g) states that "the tax commission is authorized and empowered, in its discretion and in such manner as it may determine," to make certain adjustments to items of income and deductions so as to accurately determine the tax due (emphasis added). This wording indicates that the Commissioner is authorized to make such adjustments to correct distortion, but is not required to do so. The very next sentence states:

"If, however, in the determination of the tax commission, such adjustments do not or cannot provide for the accurate determination of the tax, the commission shall be authorized to require the filing of combined reports" (Tax Law § 1462[g]; emphasis added).

Petitioner contends that the second sentence of section 1462(g) is clear and unambiguous and creates a condition precedent to combination. The Division, in its regulations, takes a different view stating:

"the Tax Commission is not required to exercise its authority under [section 1462[g] and 20 NYCRR 18-1.3] and, in lieu thereof or in addition thereto, a combined return may be required or permitted."

Taken out of context, the second sentence might appear to have the meaning ascribed to it by petitioner. But when read with the language surrounding it, as it must be, it is clear that

section 1462(g) is intended as a grant of authority to the Commissioner to make remedial adjustments, in his discretion, not as a legislative directive requiring the Commissioner to attempt such adjustments before resorting to combination. The second sentence does no more than clarify that the Division has two separate alternatives available to cure distortion -- remedial adjustments and combination. Petitioner has cited to no legislative history or policy consideration which would support its construction of the statute, and I could find none in my own review of the legislative history.

As petitioner notes, section 1462(g) has a purpose which is similar to that of section 482 of the Internal Revenue Code and section 211.5 of the Tax Law. Section 482 is a grant of authority to the Commissioner of Internal Revenue to make certain remedial adjustments among related businesses (whether incorporated or not) if necessary to prevent evasion of tax or reflect the income of those businesses. Tax Law § 211.5 contains a similar grant of authority to the Commissioner of Taxation and Finance under the business corporation franchise tax law. Section 211.5 has never been held to direct the Commissioner to attempt remedial adjustments before requiring combination. There are two significant differences between the language of section 211.5 and that of section 1462(g). Tax Law § 211.5 authorizes the Commissioner, in his discretion and in such manner as he may determine, "to adjust items of income, deductions and capital . . . so as equitably to determine the tax" (emphasis added). Section 1462(g) uses the phrase "so as accurately to determine the tax" (emphasis added). The second sentence of section 1462(g), beginning "[i]f, however" does not appear in section 211.5. I do not find that these differences demonstrate that the Legislature intended the remedial adjustment provision of section 1462(g) to be a condition precedent to combination. In sum, I conclude that the Division's regulation is consistent with the clear wording of the statute, and I find no reason to deem it invalid.

In order to make a more complete record for review, I will address petitioner's contention that the Division never attempted to make remedial adjustments before requiring combination in this case. Despite the auditors' testimony that remedial adjustments were considered but

deemed too difficult to attempt, I must agree with petitioner. There is no mention in the audit report of any such attempt. The auditors never discussed remedial adjustments with petitioner's representatives and did not request documents which might have provided a basis for making such adjustments. Even the auditors' testimony supports petitioner's allegation that the Division did not give serious consideration to the possibility of making remedial adjustments and never attempted such adjustments.

C. As stated above, Tax Law § 1462(f)(2) requires or permits combination of affiliated banking companies based upon certain stock ownership requirements, provided that a bank holding company or banking corporation not a taxpayer may not be subject to combination unless certain conditions are met. The factors to be considered in determining whether a banking corporation or bank holding company not a taxpayer may be required to file a tax return on a combined basis with a New York taxpayer are similar to those factors provided for in Tax Law § 211.4. Although there are significant differences, the Division's regulations interpreting the combination provisions of Article 32 are generally similar to those interpreting Article 9-A. 20 NYCRR 21-2.6(a) provides as follows:

"Corporations not included in a combined return. (a) A banking corporation or bank holding company which is not a taxpayer cannot be included in a combined return under section 21-2.2 of this Subpart unless it is part of a unitary business with the other corporations in the group (see section 21-2.3[b][1] of this Subpart) and the Tax Commission determines that the inclusion of such corporation is necessary in order to properly reflect the tax liability of one or more banking corporations or bank holding companies included in the group because of:

"(1) intercorporate transactions (see section 21-2.3[b][3] of this Subpart);
or

"(2) some agreement, understanding, arrangement or transaction existing between the taxpayer and any other combinable corporation, whereby the activity, business, income or assets of the taxpayer within New York State is improperly or inaccurately reflected (see section 21-2.3[b][4] of this Subpart)."

The Division's regulations state that a presumption of distortion arises where there are substantial intercorporate transactions (20 NYCRR 21-2.3[b][3][i]) and set forth the factors which will be considered in determining whether there are such transactions:

"[T]he Tax Commission will consider transactions directly connected with

the business conducted by such corporations, such as:

- "(a) performing services for other corporations in the group;
- "(b) providing funds to other corporations in the group; or
- "(c) performing related customer services using common facilities and employees.

"Service functions will not be considered when they are incidental to the business of the corporation providing such services. Service functions include, but are not limited to, accounting, legal and personnel services

"(ii) If a corporation described in subdivision (a) of this section fails to meet the presumption of improper reflection of tax liability because it does not have substantial intercorporate transactions with any other combinable corporation or with a combined or combinable group of such corporations and if the filing of a return on a separate basis nevertheless results in an improper reflection of the taxpayer's tax liability in New York State, the Tax Commission will permit or require the filing of a combined return" (20 NYCRR 21-2.3[b][3][i], [ii]).

The regulation also states that the tax liability of a New York taxpayer may be deemed to be distorted because of some agreement, understanding, arrangement or transaction between the taxpayer and some other "combinable" corporation (20 NYCRR 21-2.3[4]).

As I understand the arguments presented in the Division's brief, the Division takes the position that combination of U.S. Trust and UST Delaware is mandated by Tax Law § 1462(f)(2), and, as a consequence, petitioner bears the burden of showing that combined reporting inaccurately reflects the proper tax liability of U.S. Trust. Thus, the Division states:

"The statute in question (§1462[f][2]) by use of the word 'shall' clearly provides that a combined report is mandatory, unless the taxpayer or tax commission demonstrates that combined reports inaccurately reflect the proper tax liability" (Division's brief, p. 10).

Although I have already found that this is not a complete and accurate interpretation of the statute, I find it necessary to address the issue again because it appears from the arguments made in the Division's brief that the Division is attempting to place an evidentiary burden on the taxpayer which is not dictated by either the statute or the regulations.

As the regulations state, combination of a taxpayer and a banking corporation not a taxpayer may be required where (1) a stock ownership requirement is met; (2) there is a unitary business; and (3) there exists either substantial intercorporate transactions or some agreement,

understanding or transaction which causes the activity, business, income or assets of the taxpayer within New York to be inaccurately reflected. Because the language and intent of Tax Law §§ 211.5 and 1462(f)(2) and the regulations promulgated under the authority of those statutes are so similar, they must be interpreted in a similar fashion. In a series of cases concerning Article 9-A of the Tax Law, the Tax Appeals Tribunal has held that where a taxpayer corporation and related corporations are found to meet the three requirements for combination a rebuttable presumption arises that the taxpayer corporation's income will not be properly reflected without reporting on a combined basis. This presumption of distortion may be overcome by the taxpayer with evidence establishing that separate reporting results in the proper reflection of income (see, Matter of Campbell Sales Company, Tax Appeals Tribunal, December 2, 1993). This means that if the Division determines that combination is necessary to properly reflect a taxpayer's income because of intercorporate transactions or some other agreement or arrangement, it must identify with specificity the transactions or agreements which it relies on to support its determination. To phrase it differently, a taxpayer cannot be asked to overcome a presumption of distortion unless the Division identifies those transactions which it contends give rise to the presumption in the first place.

Two of the requirements for combination are met in this case: the stock ownership requirement and the unitary business test. Petitioner does not contend otherwise. It does, however, contend that there are neither intercorporate transactions nor an agreement, understanding or arrangement between UST Delaware and any other member of the U.S. Trust group causing U.S. Trust's New York tax liability to be improperly reflected.

D. Petitioner claims that the only substantial intercorporate transaction between itself or any other member of the UST group and UST Delaware is the custodial agreement between UST New York and UST Delaware. It established that the terms of that agreement were consistent with similar agreements between UST New York and unrelated third parties. The custodial agreement is not identified in the audit report as an intercorporate transaction causing petitioner's tax liability to be inaccurately reflected. Moreover, the Division offered no

evidence to overcome petitioner's showing that the custodial agreement was an arm's-length transaction. Consequently, it is concluded that petitioner has overcome any presumption of distortion which might be said to have arisen because of the custodial agreement.

Mr. Shanahan testified on behalf of the Division that at the time of the audit the infusion of capital into UST Delaware (in the amount of approximately \$43,000,000.00) was considered by the auditors to be a substantial intercorporate transaction. The Division did not respond to petitioner's contention that capital contributions do not constitute intercorporate transactions for the purpose of creating a presumption of distortion.

Petitioner notes that the Commissioner's regulations state that only transactions "directly connected with the business conducted by [corporations in a unitary group]" will be considered in determining whether there are substantial intercorporate transactions. Clearly, U.S. Trust cannot be considered to be in the business of making capital contributions nor can UST Delaware be considered to have been in the business of receiving such contributions. Petitioner also points to the regulations promulgated under the authority of Article 9-A of the Tax Law which give nine examples of intercorporate transactions requiring or not requiring combination. None of these include capital contributions as intercorporate transactions. I agree with petitioner that it is reasonable to construe the term "intercompany transaction" as it is used in Article 32 in the same manner as the term is construed in the regulations of the Internal Revenue Services governing Federal consolidated returns (see, Matter of Marx v. Bragalini, 6 NY2d 322, 333, 189 NYS2d 846, 854 [where the court held that whenever reasonable and practicable the Federal construction of substantially similar tax provisions should be adopted in construing State tax provisions]). Treasury Regulation § 1.1502-13 provides that "an intercompany transaction does not include a distribution by one member of a group with respect to the distributing member's stock, or a contribution to capital on which no gain is recognized" and that "dividend distributions, redemptions and liquidations are not intercompany transactions." Finally, petitioner asks that note be taken of the fact that there are no cases where the former State Tax Commission, the Tax Appeals Tribunal or a New York court has

held that a capital contribution is an intercorporate transaction. I find these arguments of petitioner compelling and agree that a contribution to capital is not an intercompany transaction within the meaning of Article 32.

In its brief, the Division states:

"It is clear that the vast majority of intercorporate transactions at issue here were not taken at arm's length. In many instances there was no attempt by UST Delaware to compensate the petitioner for services which the parent provided. These services include the selection, management strategy and legal services for the acquisition and management of subsidiaries of UST Delaware."

Without specifically identifying the services which it claims U.S. Trust provided in connection with the acquisition of subsidiaries by UST Delaware, the Division thus claims that the providing of such services was an intercorporate transaction (and, presumably that U.S. Trust assumed expenses which were properly those of its subsidiary, resulting in a decrease in New York income). Petitioner concedes that U.S. Trust, at the level of its management committee, discussed and planned the conversion of the Florida business into a non-bank bank and considered various acquisitions in other states. Petitioner states that all of these activities and the expenses related to them were properly those of the parent, U.S. Trust, and it cites to a technical advice memorandum of the Internal Revenue Service (Tech Adv Mem 88-06-002 [Sept. 24, 1987]) to support its position.

As I stated above, if a taxpayer is to be asked to overcome a presumption of distortion, it is incumbent upon the Division to first identify those intercorporate transactions which it claims give rise to the distortion. The intercorporate transactions cavalierly referred to in the Division's brief were not identified as grounds for combination on audit. There is no evidence that the Division closely examined the accounts of U.S. Trust or UST Delaware on audit to determine whether there were legal or managerial services provided by U.S. Trust to UST Delaware. The provision of services by U.S. Trust to UST Delaware is not identified in the audit report as an intercorporate transaction giving rise to the presumption of distortion. While the Division stated in its opening statement at hearing that combination is required in this case because of intercorporate transactions, it did not mention the provision of legal or managerial services at

that time. In short, there is no evidence in this record that leads me to believe that the Division determined that combination was required in this case because of managerial, legal or other services provided by U.S. Trust to UST Delaware. As a consequence, there is insufficient evidence in the record to support a finding that U.S. Trust's tax liability was inaccurately reported because of unspecified services it performed in connection with the acquisition of subsidiaries by UST Delaware.

My conclusions concerning the Division's contention that U.S. Trust assumed the legal expenses of UST Delaware are the same. At hearing, Mr. Milstein testified:

"When I examined the copies of the legal bills, or the amounts on the New York books, we saw payments made to attorneys for work performed for the Florida corporation and California corporation, and these are subsidiaries of the Delaware corporation" (tr., p. 47).

The underlined phrase demonstrates that the auditor was unable to identify which records he examined, and it does not appear that the auditor inquired of petitioner about any unreimbursed payments. The record does not reveal the basis for the auditor's conclusion that the payments he saw represented expenses of UST Delaware. As stated in the audit report, the Division's reason for requiring combination was its conclusion that UST Delaware's only purpose was to enable U.S. Trust to funnel capital and income out of New York State. The report does not mention payments made by petitioner for legal services provided to UST Delaware.

Although the Division raised these payments as an issue for the first time at hearing, petitioner attempted to meaningfully respond to the auditor's testimony through the testimony of Mr. Scarpinato, the head of U.S. Trust's corporate tax department. He testified that no legal bills were requested by the auditors or presented to them. He also testified that when the consolidated Federal tax returns are prepared by his unit, a reconciliation is made to ensure that the expenses of each corporation are properly attributed to that corporation and taxable income is properly reflected for each corporation. The Division presented no evidence to challenge his testimony which I found to be credible. In sum, there is not sufficient evidence in the record to give rise to the presumption that because of intercorporate transactions combination of U.S. Trust and UST Delaware is necessary to accurately reflect U.S. Trust's tax liability.

E. The next issue is whether U.S. Trust's New York tax liability may be deemed to be distorted because of some agreement, understanding or arrangement between it and UST Delaware. The Tax Law gives no explanation of when, or how, an agreement, understanding or arrangement will result in the improper reflection of a taxpayer's activities in New York. The Division's regulations provide as follows:

"(c) In determining whether an agreement, understanding or arrangement between the taxpayer and any other corporation or any person or firm results in an improper or inaccurate reflection of the activity, business, income or assets of the taxpayer within New York State, consideration is given to such factors as:

"(1) whether the taxpayer controls or is controlled by such other corporation, person or firm, or whether the taxpayer and such other corporation, person or firm are controlled by the same interest;

"(2) whether the agreement, understanding or arrangement in question would have been entered into, or whether the terms and conditions would have been the same, had the element of control been absent and had the parties been dealing at arm's length; and

"(3) whether the agreement, understanding or arrangement in question has a reasonable business purpose, or whether it appears to be arbitrary or to have been motivated principally by a tax avoidance purpose" (20 NYCRR 18-1.3[c]).

On audit, the Division concluded that an arrangement existed between U.S. Trust and UST Delaware which was motivated primarily by a tax avoidance purpose. It will be helpful to describe the specific arrangement identified by the Division on audit. The Division determined that UST Delaware served as a vehicle which allowed U.S. Trust (or UST New York) to channel large sums of capital outside of New York. It was the Division's understanding that UST Delaware served three functions: (1) to hold the stock of UST Florida; (2) to hold in its own name the investments made with the capital contributed to it by U.S. Trust; and (3) to provide U.S. Trust with an accounting of the money invested and the interest and dividends earned, essentially a bookkeeping function. Based on this understanding of the relationship between U.S. Trust and UST Delaware, the Division made the determination that UST Delaware was "merely a shell company"; that U.S. Trust "channeled large amounts of its cash to U.S. Trust of Delaware in the form of additional paid in capital for the purpose of having U.S. Trust of Delaware, rather than themselves, invest this cash in investments" (emphasis added);

and that U.S. Trust transferred the recordkeeping activities of these investments from New York to Delaware (presumably to remove those activities from New York). The Division concluded that this transaction was not at "arms-length" and was the kind of "agreement, understanding, arrangement or transaction" which under the law and regulations gives rise to a presumption of distortion. Petitioner contends that any arrangements or transactions between itself and UST Delaware were fair, at arm's-length and entered into for sound business reasons.

Evidence offered at hearing proved that UST Delaware was not a shell corporation. It had an active board of directors which met and set policy. It rented property and had its own employees. It paid taxes and other expenses. It maintained its own books and records.

Petitioner proved that the capital contributions made by U.S. Trust to UST Delaware were not for the purpose of having UST Delaware earn income which would otherwise be included in U.S. Trust's New York income. The evidence shows that UST Delaware was formed primarily for the purpose of holding the stock of UST Florida and with the intention of having it serve as the holding company for the stock of other banks, trust companies and investment advisory services incorporated in states other than New York. There is no evidence that this plan was entered into to avoid New York tax (see, 20 NYCRR 18-1.3[c]). Rather, the evidence shows that U.S. Trust made a decision to use a subsidiary as the vehicle for its expansion into other states for several reasons. First, U.S. Trust believed that local bank regulators and out-of-state banks would be less hostile to a non-New York holding company. In addition, U.S. Trust recognized that those states where it intended to enter into business -- Florida, California and Texas -- are unitary tax jurisdictions, and it believed that U.S. Trust would be vulnerable to combination in those jurisdictions if it directly owned the stock of the businesses operating in those states. Finally, in order to exploit the non-bank bank loophole in the BHCA, U.S. Trust believed that it would be necessary for the parent company of UST Florida to follow an extremely restrictive investment policy. To accomplish this, it was necessary for the parent to be a corporation other than U.S. Trust. In addition, U.S. Trust proved that it contributed approximately \$19,000,000.00 in capital to UST Delaware in anticipation of the move of the

corporate and unit trust divisions of UST New York from New York to Delaware.

The evidence shows that the out-of-state expansion anticipated by U.S. Trust actually occurred. In October 1986, UST Delaware acquired the shares of Summit for \$4,350,630.00. In 1989, Deltex (a wholly-owned subsidiary of UST Delaware) acquired shares of Denker and Goodwin, a Texas investment advisory company. In addition, UST Delaware made significant contributions of capital to its operating subsidiaries from the period June 1982 through August 1990: \$7,518,437.00 to UST Florida; \$5,000,000.00 to Saudi-UST; \$4,900,000.00 to UST California; and \$4,703,000.00 to Deltex.

In short, petitioner proved that the audit assumptions which formed the basis for the assessment have no factual underpinnings. In response, the Division states:

"The petitioner claims that it had a valid business reason for organizing UST Delaware and transferring over forty million dollars to it. Assuming, *arguendo*, that this allegation is true, the parent should have received some economic benefit other than the reduction of its New York Franchise Tax liability, for the transfer of its excess funds which were held by UST Delaware. Instead, the parent did not receive any distribution or benefit from the funds except to remove the income from the invested funds from the base for the computation of the New York Bank Franchise Tax.

"The focus of Tax Law Section 1462(g) and the related regulations is the economic and franchise tax consequences of entering into a particular transaction or interrelationship relating to the proper reflection of income; the statute does not directly address the intent of the taxpayer or any of the parties of the transaction. There does not have to be any 'malevolent' intent on the part of the taxpayer or indeed on the part of any other party to the transaction: the statute clearly refers only to the result of creating an improper net loss or net income. A 'business purpose' for a transaction does not eliminate the economic effects of an intercorporate relationship and agreements which fail to properly reflect income.

"Section 1462(g) describes various results that can occur between affiliated corporations because of intercorporate transactions or agreements. Nothing in the statutes, regulations, or judicial decisions states that there must be some 'malevolent' intent in such intercorporate transactions. The statute looks only to the result and not why it was achieved or the intent behind the parties in structuring a transaction in a particular way. It is clear that the result of the transactions between the petitioner and UST Delaware was the improper allocation of income to Delaware" (Division's brief, pp. 13-14; emphasis in original).

The Division is correct in stating that the Tax Law does not refer to "malevolent intent". The Tax Law does state that a banking corporation or bank holding company which is not a taxpayer cannot be included in a combined return unless combination "is necessary in order to

properly reflect the tax liability under [article 32], because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in subsection (g)" (Tax Law § 1462[f][2][i][B]). The type of transaction referred to in subsection (g) is one which causes the activity, business, income or assets of the taxpayer within the State to be inaccurately reflected.

The only case cited by the Division to support its position that combination of UST Delaware with petitioner is necessary to properly reflect U.S. Trust's New York income is Matter of British Land (Maryland) (Tax Appeals Tribunal, September 3, 1992, confirmed ___ AD2d ___, 609 NYS2d 439). The issue in that case was whether the petitioner's acquisition and sale of certain Baltimore property constituted conduct of a unitary business. Citing to Allied-Signal v. Director, Div. of Taxation (___ US ___, 112 S Ct 2251), the Tribunal stated that the unitary business test focuses on functional integration, centralization of management and economies of scale which could be demonstrated by: transactions not undertaken at arm's length, a management role by the parent which is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business.

I agree with the Division that U.S. Trust played a dominant management role in the business affairs of UST Delaware. Petitioner concedes that it was U.S. Trust's management committee which developed policies, made long-range plans for expansion of U.S. Trust into markets outside of New York, and investigated business opportunities. It can be concluded from the evidence that the board of directors of UST Delaware made decisions and adopted policies in conjunction with U.S. Trust's board of directors (with the exception of Mr. Callaway, all members of the UST Delaware board were members of the U.S. Trust board). It is also apparent that there was a flow of value from U.S. Trust to UST Delaware. U.S. Trust's contributions to the capital of UST Delaware clearly demonstrate a flow of value. However, I cannot agree with the Division that these contributions constitute an intercorporate transaction not undertaken at arm's length. The capitalization of a subsidiary by its parent is not the equivalent of a loan as the Division seems to suggest. In return for its capital, the parent

receives an ownership interest in the subsidiary. The fact that UST Delaware paid no dividends to its parent during the audit period does not establish that the contribution to capital was not an arm's length transaction. As petitioner notes, the benefits received by U.S. Trust from its subsidiaries exist in the form of the increased value of those subsidiaries and will be realized on sale or liquidation of the subsidiaries. Finally, it is undisputed that UST Delaware is in the same business as U.S. Trust, the banking business. All of this serves to prove that U.S. Trust and UST Delaware were engaged in a unitary business enterprise, a proposition which has never been in issue. It does not show that U.S. Trust's income was improperly reflected by separate filing. There is not substantial evidence in the record to support a conclusion that combined filing is necessary to properly reflect petitioner's tax liability; therefore, tax asserted on this basis shall be cancelled.

F. Petitioner contends that if combination is appropriate the receipts of UST Delaware should not be included in New York receipts for the purposes of determining the receipts factor used to compute the New York allocation percentage. Generally, the receipts factor is determined by dividing 100 percent of the taxpayer's business receipts, earned in New York, by the total amount of the taxpayer's business receipts, earned within and without New York (Tax Law § 1454[a][2]; 20 NYCRR 19-6.1). For the audit years, all of UST Delaware's business receipts were from investment activity. Under section 19-6.5 of the Division's regulations, income from investment and trading activity is to be allocated to New York if the greater part of the income-producing activity which relates to the investment activity occurs within New York. To determine where the incoming-producing activity occurred, the Division looks to the following factors:

"(1) where the particular policies of the taxpayer regarding the trading or investment activities are established and guidelines set up;

"(2) where the day-to-day decisions regarding each transaction relating to the trading or investment activities are made; and

"(3) where the equipment and other support activities relating to such trading or investment activities are located.

"The significance to be accorded to each factor depends upon the facts in each case.

Consideration shall also be given to where the general policies of the taxpayer regarding the trading or investment activities are established and guidelines set up. However, this shall not be accorded as much significance as any of the factors enumerated in paragraphs (1), (2) or (3) of this subdivision" (20 NYCRR 19-6.5[c]).

UST Delaware's general policies regarding trading and investment activities were established by its board of directors. It is not at all clear from the record where the board of directors met. However, the regulations state that the situs of the general policy making activities are of less importance than the day-to-day decisions regarding each transaction. In reality, there was little decisionmaking regarding individual transactions. The policy established by the board was restrictive and precise. Under the custodial agreement the trading facilities of UST New York were used to make purchases and sales of securities within the parameters of UST Delaware's policy. UST New York's traders made the initial decisions regarding investments. The arrangement between UST Delaware and U.S. Trust allowing traders to execute transactions within guidelines established by the custodial customer is not unusual. The evidence adduced at hearing establishes that Mr. McNeily, as UST Delaware's chief investment officer, had the responsibility to oversee investments made by the traders in New York and the authority to overturn their decisions if he believed that an investment did not fall within the policy set by the UST Delaware board of directors. The evidence also establishes that Mr. McNeily's oversight activities took place in Delaware and that recordkeeping and other support activities relating to the investments took place in Delaware. I agree with petitioner that more weight should be given to the place where the investment authority is located than the place where the actual trading took place. Therefore, I conclude that UST Delaware's business receipts are properly treated as non-New York receipts for purposes of entire net income allocation.

G. The next issue to be addressed is whether the eligible business facility credit should be calculated on a combined basis. Tax Law § 1456(b)(1) provides:

"On or after April first, nineteen hundred eighty-three, a credit against the tax imposed by this article shall be allowed only to a taxpayer owning or operating an eligible business facility, where such taxpayer has received a certificate of eligibility for tax credits, or a renewal or extension thereof, for such facility from

the New York state job incentive board prior to April first, nineteen hundred eighty-three, or has received a certificate of eligibility for tax credits, or a renewal or extension thereof, for such facility from the state tax commission subsequent to such date pursuant to paragraph eight of this subsection, and only with respect to such facility, to be computed as hereinafter provided."

Generally speaking, the credit is calculated by a formula that includes the average value of the taxpayer's real property and tangible personal property located in New York and of the wages, salaries and other personal compensation of employees located in New York (Tax Law § 1456[b][2]). The statute contains no reference at all to taxpayers filing on a combined basis; however, the Division's regulations provide that in computing the eligible business facility credit for corporations filing on a combined basis the credit is to be determined by a formula that includes the property and wages within New York of all corporations included in the combined return. Petitioner argues that the Division's policy of requiring the credit to be calculated on a combined basis is not supported by the statute and is erroneous. Petitioner argues that calculation of the credit on a combined basis is contrary to the underlying intent of the eligible business facility credit. Essentially, petitioner argues that the credit should be claimed by and granted to the taxpayer eligible to receive the credit under Tax Law § 1456(b), i.e., the corporation that owns or operates eligible facilities. Petitioner argues further that corporations which do not own the eligible facility should not receive the benefit of the credit. Petitioner states that the corporation owning and operating the eligible facility is UST New York. I note, however, that the certificate of eligibility was issued to U.S. Trust and not to UST New York.

As the Division noted, Tax Law § 1462 mandates combined reporting by all affiliated banking corporations and bank holding companies doing business in New York where an 80% stock ownership test is met. Essentially, this creates an irrebutable presumption that the tax liability of certain affiliated corporations are properly reflected by the filing of a return on a combined basis. In light of this general policy, it was reasonable for the Division to require that the eligible business facility credit be calculated on a combined basis for all New York taxpayers. There is no evidence in the statute that the Legislature intended to exempt the

eligible business facility credit from this general rule of combination. Petitioner offers two hypotheticals to demonstrate that as a result of combination a corporation not otherwise eligible for the credit would receive the benefit of the credit. These hypotheticals merely establish that the credit may benefit a group of affiliated corporations more or less depending on particular circumstances. They do not show that calculating the credit on a combined basis violates the intent of the Legislature. It is well established that the construction given statutes by the agency responsible for their administration should be upheld, if not irrational or unreasonable (Matter of Howard v. Wyman, 28 NY2d 434, 322 NYS2d 683).

H. With respect to that portion of the assessment attributable to petitioner's calculation of the eligible business facility credit, the Division imposed a penalty under Tax Law § 1085(k) which provides, in pertinent part, as follows:

"Substantial understatement of liability. -- If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent of the amount of any underpayment attributable to such under- statement The amount of such understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return" (emphasis added).

Petitioner claims that the computation of tax of the eligible business facility credit claimed by UST New York satisfies the adequate disclosure requirements of Tax Law § 1085(k). The Division has not promulgated regulations under Tax Law § 1085(k). However, Tax Law § 1085(k) is substantially the same as IRC former § 6661, and the Division has issued a memorandum (TSB-M-83[16]C) describing its interpretation of the statute which is substantially the same as Treasury Regulation § 1.6661-4(a). It is appropriate, therefore, to refer to the Federal regulation and case law in determining whether the penalty assessed should be reduced.

Under Treas Reg § 1.6661-4(a), items for which there is adequate disclosure are treated as if they were shown properly on the return for the taxable year, for purposes of computing the amount of the tax shown on the return. Generally, disclosure is considered to be adequate if it

takes the form of a separate statement containing certain information prescribed by the Commissioner of the Internal Revenue Service (the "Commissioner") (Treas Reg § 1.6661-4[b]). The Commissioner may by revenue procedure prescribe the circumstances in which information provided on a return will be deemed to be adequate disclosure without necessity of a separate statement (Treas Reg § 1.6661-4[c]). Under rules prescribed in revenue procedures, the IRS has required that, to the extent specified in the forms and instructions, items must be separately stated on the appropriate line, money amounts entered must be verifiable, and the taxpayer must be able to show that it entered the number on the applicable form in good faith (see, e.g., Rev Proc 92-23, 1992-1).

Although it has not promulgated regulations, the Division's memorandum states:

"Disclosure is adequate with respect to the tax treatment of an item on a return only if it is made on such return or in a statement attached thereto" (TSB-M-83[16]C).

Thus, it appears that in New York disclosure of a taxpayer's position is adequate if it is disclosed on the return, without resort to a separate statement.

The eligible business facility credit is calculated on form CT-45 and the amount of the credit is then transferred to the combined franchise tax return (form CT-32A). Instructions for completing form CT-45 are provided on the back of the form. The instructions do not directly address combined filers. An instruction on the front of the form states: "File with your franchise tax report Form CT-3, CT-32 or CT-33". Form CT-32A, the combined return, is conspicuously missing from the list. Under the heading, "Computation of Tax Credit", the instructions refer to "your real property", "your tangible personal property" and "your Certificate of Eligibility". Petitioner interpreted the "you" being addressed in this instruction as the corporation owning and operating the eligible business facility, in this case, UST New York. This was an erroneous interpretation. The certificate of eligibility was not issued to UST New York; it was issued to petitioner, U.S. Trust (and bears the Employment Identification Number of petitioner). However, it is understandable that petitioner drew the conclusion that it did since form CT-45 makes no reference to combined filers, or to the combined filing franchise tax form (CT-32A) and instructs the taxpayer to enter the amount of the tax as calculated on form CT-32.

Since UST New York was the only one of the affiliated corporations which owned or operated an eligible business facility, petitioner believed that the credit should be computed by taking into account only the values of UST New York. Based on these facts, I find that petitioner acted in good faith when it calculated the eligible business facility credit as it did. In addition, the reports clearly show that the amount of the credit claimed by U.S. Trust was calculated on a separate basis and that the credit originated from petitioner's calculation of the credit based upon the separate tax liability of UST New York. In this manner, petitioner disclosed its position on the face of the return. The Division did not address the penalty issue in its brief and has not offered any reason for not finding that the disclosure was adequate in this instance. I find that with respect to the eligible business facility credit relevant facts affecting the item's tax treatment were adequately disclosed in petitioner's tax returns and cancel the additional charges asserted for the audit years.

I. The petition of U.S. Trust Corporation is granted to the extent indicated in Conclusions of Law "E", "F" and "H"; the notices of deficiency for the years 1985, 1986 and 1987 shall be modified accordingly; and, in all other respects, the petition is denied.

DATED: Troy, New York
December 22, 1994

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE